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PRISONERS NO MORE: STATE INVESTMENT RELOCATION INCENTIVES AND THE PRISONERS' DILEMMA

Daniel P. Petrov*

INTRODUCTION

It is a central concern of governments to improve the economic climate of their territory. This is true for states of all sizes, from nations to local townships. Central to their economic success is a strong base of commercial and industrial investment. States use a number of methods to attract investment, such as improving public services, proximity to markets and raw materials, and the quality of labor.¹ Increasingly, states are relying on a controversial method to attract investment: investment relocation incentives.² While the majority of the evidence shows that these incentives do little to actually attract investment, the states continue to engage in incentive wars.³

A number of commentators have argued that the states persist in unproductive incentive wars because they are trapped in a prisoners' dilemma.⁴ The prisoners' dilemma suggests that states would not grant incentives if they could ensure that no other state would.⁵ However, because they do not wish to fall behind other states in the bidding for investment, they grant incentives, despite their harmful effects. While this model successfully describes why a state may enact an incentive even after it decides that it will not be beneficial, it fails to consider the alternative reasons a state may have for wanting to grant an incentive. Because of this deficiency of the prisoners' dilemma as an explanatory tool, this Note

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¹ See Robert G. Lynch, *The Effectiveness of State and Local Tax Cuts and Incentives: A Review of the Literature*, 11 STATE TAX NOTES 949-53 (1996).

² See Peter Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 377, 380 (1996).

³ See *id.*

⁴ See Matthew Schaefer, *State Investment Attraction Subsidy Wars Resulting from a Prisoner's Dilemma: The Inadequacy of State Constitutional Solutions and the Appropriateness of a Federal Legislative Response*, 28 N.M. L. REV. 303 (1998); see also Enrich, *supra* note 2, at 396-97.

⁵ See *infra* notes 75-82 and accompanying text.

argues that the prisoners' dilemma scenario must be adjusted to grasp the complexities of potential justifications for relocation incentives.⁶

Section II of the Note provides a brief background outlining investment attraction incentives and their theoretical effects. Section III first explains how the prisoners' dilemma has been applied in the context of investment relocation decisions. It then compares the national treatment of incentives in the United States and in Canada. Section IV argues that much of the literature on relocation incentives uses the prisoners' dilemma to explain only a portion of a state's possible motivations in enacting incentives.

II. BACKGROUND OF INVESTMENT RELOCATION INCENTIVES

A. Investment Relocation Incentives Defined

Investment attraction incentives belong to one of two categories: 1) tax incentives; and 2) non-tax incentives, or subsidies.⁷ Tax incentives are typically exemptions, credits, refunds or abatelements from state taxes, while subsidies can take any of a number of forms: cash grants, loans and financing, or preferential government purchasing practices.⁸ Regardless of type, these incentives "all share a common purpose: to enhance the state's attractiveness as a place for businesses to locate their facilities and their jobs."⁹

Investment attraction incentives share three common characteristics.¹⁰ First, incentives are narrowly focused on specific industries or economic sectors.¹¹ Second, incentives are "fairly direct, requiring cash outlays from governmental treasuries and creating tax burdens borne by the general public."¹² Finally, incentives can be characterized as "conscious efforts to influence the future direction of state economies."¹³

⁶ See *infra* Section IV.

⁷ See Schaefer, *supra* note 4, at 306-7; see also Enrich, *supra* note 2, at 384-85.

⁸ See Schaefer, *supra* note 4, at 306-7; see also Enrich, *supra* note 2, at 385.

⁹ Enrich, *supra* note 2, at 387.

¹⁰ See Mark L. Taylor, *A Proposal to Prohibit Industrial Relocation Subsidies*, 72 TEX. L. REV. 669, 676 (1994).

¹¹ See *id.*

¹² *Id.*

¹³ *Id.*

B. Theoretical Effects of Investment Relocation Incentives

Traditional economic theory indicates that unless offered to correct for an externality or a market failure, state investment attraction incentives distort interstate trade, thus reducing the national welfare.¹⁴ Trade literature provides a useful model to illustrate the effects of state incentives on three categories of states: 1) the subsidizing state; 2) states which are net importers of a product manufactured in a subsidizing state; and 3) states which are net exporters of a product manufactured in a subsidizing state.¹⁵ This model of theoretical effects of incentives is equally valid for both tax incentives and non-tax subsidies, as the real-world effect of a tax credit is equivalent to that of a cash subsidy.¹⁶

1. Effects of Incentives on the Subsidizing State

When a state offers an investment attraction incentive to an industry, it incurs costs, while reaping benefits. In addition to the lower price that its citizens will pay for the subsidized good,¹⁷ the state will reap the marginal benefits of newly created jobs and increased tax revenue generated by the increased income, spending, and property values of both the new industry and its citizens.¹⁸ At the same time, the state will have to bear the cost of the incentive.¹⁹ A state that offers an investment relocation

¹⁴ See Bernard S. Friedman, *Subsidies*, in THE MCGRAW-HILL ENCYCLOPEDIA OF ECONOMICS 964, 966 (Douglas Greenwald ed., 2d. ed. 1994); see also Peter Gerhart, Lecture, A Typology of International Economic Law (Nov. 4 1999) (lecture notes on file with author).

¹⁵ See Schaefer, *supra* note 4, at 307; See also generally JOHN JACKSON, THE WORLD TRADING SYSTEM 250-254 (2d ed., 1997).

¹⁶ See CAMPBELL R. MCCONNELL, ECONOMICS, 150 (J.S. Dietrich et al. eds., 7th ed. 1978) (explaining that because subsidies "rechannel tax revenues back to households and businesses, these payments in effect are 'negative taxes.'"). See also Walter Hellerstein & Dan T. Coenen, *Commerce Clause Restraints on State Business Development Incentives*, 81 CORNELL L. REV. 789, 835 (1996) (noting that "[e]conomists know that the real-world impact of such a subsidy mirrors the effect of the [tax] credit" (citing ROBERT L. HEILBRONER & LESTER C. THUROW, *ECONOMICS EXPLAINED* 173 (updated ed. 1987))).

¹⁷ See Friedman, *supra* note 14, at 964 (explaining that "[s]ubsidies generally allow a buyer to receive a good or service for a lower price than would otherwise have been necessary"); see also BRANKO HORVAT, THE THEORY OF INTERNATIONAL TRADE, 132-33 (1999) (comparing the effects of subsidies to those of tariffs).

¹⁸ See Schaefer, *supra* note 4, at 308-9 (indicating that subsidizing states may experience a net gain in tax revenues generated by having resident industries).

¹⁹ See Enrich, *supra* note 2, at 387-88 (citing states' tax-expenditure reports to demonstrate the great costs incurred by attraction subsidies).

incentive to an industry suffers a welfare reduction because the incentive results in the production of goods to the point where marginal costs exceed the marginal benefits.²⁰

Incentives have the additional effect of enhancing the exportability of the subsidized product into an importing state.²¹ This is because the producer of the subsidized product is able to offer the product at a lower cost than would be possible without the subsidy.²² Conversely, the incentive may restrain imports to the subsidizing state.²³ The producer of the subsidized product is again able to offer the product at a lower cost than would be possible without the incentive, which is also presumably lower than the cost offered by the out-of-state producer.²⁴

Incentives do not always cause a welfare reduction.²⁵ In some cases, an incentive may provide correction for an externality or a market failure.²⁶ In other words, the subsidized industry may provide benefits to the state that are not accounted for by the market.²⁷ Professor Matthew Schaefer points to the subsidization of dairy farmers in Massachusetts as an incentive which arguably corrects for a market failure: "the existence of dairy farms in Massachusetts, it might be argued, has a value, namely enhancing the culture, the atmosphere, and perhaps even tourism of the state, that is not captured by the market."²⁸

2. Effects of Incentives on States that are Net Importers of a Product Manufactured by an Industry Subsidized by Another State

A state that is a net importer of a product that is manufactured by an industry subsidized by a neighboring state may actually experience a short-term increase in welfare.²⁹ The net importing state will receive the

²⁰ See Schaefer, *supra* note 4, at 307.

²¹ See JACKSON, *supra* note 15, at 250.

²² See Friedman, *supra* note 14, at 964 (pointing out the U.S. hospital subsidies as an example of how subsidies lower a consumer's cost paid for the subsidized good).

²³ See Jackson, *supra* note 15, at 250-51.

²⁴ See *id.*

²⁵ See Friedman, *supra* note 14, at 966.

²⁶ See Schaefer, *supra* note 4, at 308; see also Gerhart, *supra* note 14.

²⁷ See Schaefer, *supra* note 4, at 308.

²⁸ Schaefer, *supra* note 4, at 308. Schaefer also notes that "similar arguments are in fact made by the European Community in international trade negotiations regarding its small farmers." *Id.*

²⁹ See *id.*

benefit of lower prices for the subsidized product.³⁰ If the benefit of lower prices to local consumers outweighs the potential costs caused by another state's incentive, the importing state will receive a net welfare gain.³¹

These gains are likely to be short-lived for a number of reasons.³² First of all, it may be difficult to achieve a Pareto improvement, that is, to redistribute the gains received by the local consumers to the producers who bear the costs.³³ While the consumers may be better off with the imported good subsidized, the local producers may be unable to compete with the lower price of the imported good.³⁴ In this situation, the state may actually suffer a decrease in welfare because the loss experienced by the state's local producers may be more burdensome to the state than the local consumers' gains are beneficial. The state could potentially suffer costs in the form of lost jobs, lower tax revenues, and lost profits of local producers, who are unable to match the low price offered by their subsidized competitor.³⁵

Secondly, if the subsidization is predatory (i.e., seeking to eliminate competition), welfare gains will quickly disappear as local producers are driven from local and neighboring markets.³⁶ Finally, the incentive may prevent industry from moving to the importing state, bringing numerous benefits, such as jobs, tax revenue, and lower costs of societal benefit payments to that state.³⁷

3. Effect of Incentives on States that are Net Exporters of a Product Manufactured by an Industry Subsidized by Another State

A state which is a net exporter of a product manufactured by an industry subsidized by a neighboring state will suffer a welfare loss for many of the same reasons as a net importing state.³⁸ Just as the importing

³⁰ See JACKSON, *supra* note 14, at 250; see also Schaefer, *supra* note 4, at 308; see also GARY C. HUFBAUER & JOANNA SHELTON ERB, *SUBSIDIES IN INTERNATIONAL TRADE* 5 (1984).

³¹ See Schaefer, *supra* note 4, at 308.

³² See Schaefer, *supra* note 4, at 309.

³³ See Martin C. McGuire, *Normative Economics*, in *THE MCGRAW-HILL ENCYCLOPEDIA OF ECONOMICS*, 744-45 (Douglas Greenwald ed., 2d ed., 1994). The Pareto criterion is a widely-accepted tool for evaluating alternative states. It proposes that one situation (X) is a Pareto improvement over another (Y) if no person is worse off at X than at Y, and at least one person is better off at X than at Y. See also Schaefer, *supra* note 4, at 309.

³⁴ See JACKSON, *supra* note 15, at 250.

³⁵ See Schaefer, *supra* note 4, at 308.

³⁶ See *id.* at 309; see also HUFBAUER & SHELTON ERB, *supra* note 30, at 5.

³⁷ See Schaefer, *supra* note 4, at 309.

³⁸ See *id.*

state, the net-exporting state will benefit from the lower price of the imported goods, but suffer the loss of profits and sales of local producers.³⁹ However, the exporting state is more vulnerable to the neighbor's incentive than a net-importing state. This is because as a net-exporter, the state by definition exports more goods than it imports. This virtually guarantees that the harm experienced by local producers will exceed the local consumer benefit of lower prices for the subsidized good.⁴⁰

It is important to realize that a state that is a net exporter relies on its products being sold outside of its borders for its income. It is impossible for an exporting state to sell its products outside of its borders if neighboring states are offering the same product for lower prices. Therefore, the incentive may act as a trade barrier not only around the subsidizing state, but also around other net-importing states.⁴¹ The exporting state suffers additional harm for each state in which the subsidized good is offered for a lower price than its own exported good.

4. Benefits of Incentives

Investment relocation incentives cause potentially negative economic effects in both subsidizing and neighboring states. However, there are two major benefits for subsidizing states. The first of these is local autonomy.⁴² Granting incentives to corporations "allows small groups of like-minded individuals to control their own destiny."⁴³ When states experiment with social and economic policy independently, the nation as a whole has the opportunity to see the comparative effects of the different policies.⁴⁴ At the same time, other communities within the nation are insulated from the consequences of economic experimentation if the

³⁹ See *supra* notes 29-38 and accompanying text.

⁴⁰ See Schaefer, *supra* note 4, at 309.

⁴¹ See JACKSON, *supra* note 15, at 250. Jackson gives the following example: "[S]ubsidies from country A can enhance the exportation of its products to a third country, C, where they compete with similar products that are exported from country B." *Id.* In Jackson's example, country A represents the subsidizing state, country C represents the net-importing state, and country B represents the net-exporting state. Country A's subsidies may present trade barriers to many of country B's trading partners, thus causing considerable harm.

⁴² See Taylor, *supra* note 10, at 691.

⁴³ *Id.*

⁴⁴ See *id.* (citing *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) ("It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.")).

experiment fails.⁴⁵ This insulation effect of state-level experimentation allows states that wish to make their business environments more attractive to outside investment to choose between short-term benefits of incentives and the long-term benefits of increasing budgets for education and workforce training.⁴⁶

Incentives can provide a second benefit by enhancing the economic competitiveness of the state.⁴⁷ Offering incentives, which target corporations are likely to view as a “pro-business investment” on the state’s part, gives immediate evidence of the state’s desire to improve their business environment.⁴⁸ State incentives may also raise the economic competitiveness of the nation as a whole if they are offered to corporations in neighboring countries.⁴⁹

5. Two Competing Views of the Effectiveness of Investment Relocation Incentives:⁵⁰

a. Incentives as an Effective Tool for Attracting Investment⁵¹

One version of the theoretical effects of state investment relocation incentives asserts that incentives are effective in attracting investment, and that a state can change the location decision of a business by granting incentives.⁵² Incentives, such as an educated workforce or proximity to natural resources can help a state overcome the economic advantages of its neighbors.⁵³ If a state uses incentives properly, it will be able to attract

⁴⁵ See *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

⁴⁶ See generally Gerhart, *supra* note 14 (giving examples of expenditures that may make a state’s business environment more attractive to outside investment).

⁴⁷ See Taylor, *supra* note 10, at 691-92.

⁴⁸ *Id.* at 692.

⁴⁹ See *id.* at 691-92 (noting that state subsidies are “sometimes justified as a means of economic competitiveness that enhances the United States position in the world marketplace.”) (citing Marco Menezes & Lawrence W. Morgan, *P.A. 198: Michigan’s Industrial Property Tax Abatement Law: Fortune or Futility?*, 7 COOLEY L. REV. 139 (1990)) (characterizing Michigan’s incentive program as a “response to cyclical economic fluctuations and long-term restructuring of the global economy”).

⁵⁰ See Schaefer, *supra* note 4, at 309-10. Schaefer’s framework highlights the major arguments of the two competing views on state subsidy wars. Other contributors to the discussion are noted within this Note.

⁵¹ See *id.* at 309.

⁵² See *id.*

⁵³ See *id.*

investment, increase its tax revenue, and enhance its growth much more quickly than with long-term strategies.⁵⁴

If this first version is correct, states should be essentially free to enact incentives if they believe it to be in their best interest. A state's local autonomy will allow it to determine whether its business environment will be better served by focusing on short-term benefit by granting incentives, or by focusing on long-term improvement by raising educational and workforce standards. There is still a risk that states may improperly identify and measure externalities when granting incentives, which will result in an inefficient allocation of resources.⁵⁵

b. Incentives as an Ineffective Tool for Attracting Investment

The second version of state relocation argues that businesses make their location decisions "based on the general business climate of a state and other natural advantages of locating within the state."⁵⁶ This presents two possible outcomes. The first possibility is that incentives are not substantial enough to overcome the locational advantages of their neighbors, leading a business to locate in the state they would have picked without consideration of the incentive.⁵⁷ The alternative possibility is that competing incentives offered by neighboring states cancel each other out, again leading a business to locate in the state they would have picked without consideration of the incentive.⁵⁸

If this second version is correct, one must come to the inescapable conclusion that incentives are "unnecessary 'give-aways.'"⁵⁹ Even if a state is accurately measuring externalities, the incentive it grants will have no effect on the location decision of a business.⁶⁰

The state may also face the danger of manipulation by industry. Incentives are often objected to on the grounds that they favor industry special interests that have the finances to manipulate the political process.⁶¹ Public choice theory suggests that national trade policies are formed by interest group politics.⁶² Firms that are well-organized and well-financed

⁵⁴ See *id.*

⁵⁵ See *id.* at 310.

⁵⁶ *Id.* at 309.

⁵⁷ See *id.*

⁵⁸ See *id.*

⁵⁹ *Id.*

⁶⁰ See *id.*

⁶¹ See Taylor, *supra* note 10, at 688.

⁶² See Alan O. Sykes, *The Economics of Injury in Antidumping and Countervailing Duty Cases*, 16 INT'L REV. L. & ECON 5, 18 (1996); see also Schaefer, *supra* note 4, at 310 (suggesting that incentives are a particularly attractive option for state politicians, who

are likely to exert considerable influence on state policy formation, particularly if a state believes the firm will consider the state's incentive policy when choosing a location.⁶³ This presents a problem for the state that may be pressured into granting an incentive that is either too large or completely unnecessary. In addition, small companies may be hurt because they lack the political influence of their larger counterparts.⁶⁴

6. Which Version is Closer to the Truth?

According to Schaefer, "empirical data and surveys of business executives indicate that the second version is closer to reality than the first, although there is some indication that incentives may act as a 'tie-breaker' if all other factors are equal."⁶⁵ The effectiveness of incentives has been studied through both survey and econometric research.⁶⁶ Survey research asks businesses about the influence of taxes and incentives on investment location decisions. The overwhelming majority of the surveys indicate that tax incentives "play little or no role in investment decisions."⁶⁷ The econometric studies show similar results, concluding that state incentives fail in stimulating state economic growth.⁶⁸

receive more favorable attention by attracting employers than by focusing on long-term strategies such as raising education standards); *see also* Enrich, *supra* note 2, at 389 ("In a period marked by weak economic growth and diminishing economic opportunities for many workers, the creation and retention of good jobs has inevitably become a political priority for state governments." *Id.*).

⁶³ *See* Sykes, *supra* note 62, at 18.

⁶⁴ *See id.*

⁶⁵ Schaefer, *supra* note 4, at 310.

⁶⁶ *See* Lynch, *supra* note 1, at 949.

⁶⁷ *Id.* Lynch explains that "hundreds of surveys" come to the conclusion that incentives do not influence business location decisions. *Id.* However, he notes that recent surveys have found that tax incentives played a role in location decisions, particularly for those businesses that had received incentives. Lynch is skeptical of those findings, though, believing that businesses may "exaggerate the positive effects of tax incentives on their investment decisions," knowing they may influence future policy. *Id.* at 949-50. Lynch explains that "[a] business executive who admits that the incentive received by his/her firm had no effect might cause political problems for the firm if specific survey responses became known. Furthermore, even if there is little risk of specific survey responses being released, executives responding to the survey might feel enough solidarity with business political interests to want the general findings of the study to indicate that tax and other incentives for business are needed." *Id.* at 950. (*quoting* Timothy Bartik, *Who Benefits from State and Local Economic Development Policies?*, W.E. UPJOHN INSTITUTE FOR EMPLOYMENT RESEARCH 21 (1991)).

⁶⁸ *See id.* at 950 (summarizing the main findings of the studies, which conclude that "[t]here is no evidence that state and local tax cuts, when paid for by reducing public

State taxes represent a small portion of corporate budgets, too small to greatly influence business location decisions.⁶⁹ Businesses are more likely to be influenced by factors that characterize the business environment of the state, such as wages, employee skill levels, availability of raw materials, strength of markets, and regulatory stringency.⁷⁰ One must be careful not to draw a concrete line between these influencing factors, with incentives on one side and other labor and market factors on the other. Incentives are very much intertwined with these other influencing factors, and often the presence of an incentive will indicate the absence of stringent regulations.⁷¹ For example, a state that grants an incentive may have less money to raise education levels, but it will also have less money to enforce environmental regulations. Businesses do not focus on the factors individually, but as integrated parts of a state's business environment.

Regardless of fiscal success or failure, incentives improve the business environment of the state in other subtle ways. Granting an incentive will inevitably make a state more attractive to the business community by appealing to "the business community's perception of the state's responsiveness to business concerns."⁷² Along similar lines, granting incentives may also appeal to the sensibilities of state residents, who may appreciate the government's attempt to stimulate local growth.⁷³ Of course, this must be understood with the caveat that politicians may try to conceal from their constituents the fact that an incentive is ineffective.⁷⁴

services, stimulate economic activity or create jobs," "[t]here is little evidence that the level of state and local taxation figures prominently in business decisions," and that "[f]actors such as the cost and quality of labor, the quality of public services..., the proximity to markets, and the access to raw materials and supplies are more important than tax incentives in business location decisions").

⁶⁹ See Enrich, *supra* note 2, at 392.

⁷⁰ See *id.*

⁷¹ See Gerhart, *supra* note 14.

⁷² Enrich, *supra* note 2, at 393-94. Enrich observes that "businesses that stand to benefit from state incentives have learned to fuel the interstate competition," and that "[b]usinesses have become increasingly adept at playing the states off against one another to stimulate more attractive offers." *Id.* at 394-95.

⁷³ See *id.* at 394 (noting that "[b]y taking visible steps to encourage economic growth, [politicians] can take credit for subsequent economic successes, whatever their actual causes, and avoid blame for any losses of jobs to other states that otherwise would have been attributed to them if they had failed to act. From a political perspective, doing something is almost always better than doing nothing, particularly in regard to an issue about which voters care deeply." *Id.*)

⁷⁴ See *id.*

III. THE PROBLEM OF INVESTMENT RELOCATION INCENTIVES

A. *The Prisoners' Dilemma and its Relation to Investment Attraction Incentives*

Many commentators have expressed the idea that states involved in incentive wars are faced with the classic prisoners' dilemma.⁷⁵ The prisoners' dilemma is a game theory model used to illustrate typical problems of policy formation when involved parties are unable to secure a binding, enforceable agreement.⁷⁶

Two prisoners are separately interrogated by the authorities, who attempt to extract confessions from each implicating the other. If both are silent, each will go free. If both confess, each will get a moderate sentence. If one confesses and the other does not, the former will get a light sentence and the latter a heavy sentence. Accordingly, both prisoners would be best off if each remains silent, but each fears the other will confess. To avoid the danger of the heavy sentence [that would follow from the other's confession], each confesses and incurs a moderate sentence. The prisoners are unable to reach their preferred outcome (total silence) because they are unable to communicate and reach a binding agreement.⁷⁷

The following diagram can illustrate the problem.⁷⁸

Outcome is (P ₁ 's sentence, P ₂ 's sentence)	P ₁ doesn't confess	P ₁ confesses
P ₂ doesn't confess	(0 years, 0 years)	(1 year, 10 years)
P ₂ confesses	(10 years, 1 years)	(5 years, 5 years)

⁷⁵ See Schaefer, *supra* note 4, at 311; see also Enrich, *supra* note 2, at 396-97; Taylor, *supra* note 10, at 693; Steven R. Little, Comment, *Corporate Welfare Wars: The Insufficiency of Current Constraints on State Action and the Desirability of a Federal Legislative Response*, 22 HAMLINE L. REV. 849, 858-859 (1999).

⁷⁶ See Schaefer, *supra* note 4, at 311. See also James A. Brander, *Economic Policy Formation in a Federal State: A Game Theoretic Approach*, in INTERGOVERNMENTAL RELATIONS 33, 41-42 (Richard Simeon ed., 1985).

⁷⁷ Taylor, *supra* note 10, at 693, n.155 (citing Richard B. Stewart, *Environmental Regulation and International Competitiveness*, 102 YALE L.J. 2039, 2058 n.84 (1993)).

⁷⁸ The numerical values assigned to each of the four outcomes are merely representative of what may be a light, moderate, or a heavy sentence. For further discussion of the problems with assigning values for outcomes in the prisoners' dilemma model, see notes 266-269 and accompanying text.

The prisoners' dilemma can be used as a model to demonstrate some of the problems states have when deciding whether to offer investment attraction incentives. According to most evidence, states would be better off if no incentives were offered.⁷⁹ However, if a state chooses not to offer a incentive and other states do, the former state will likely lose tax revenue and investment capital to the latter state which has granted the incentive.⁸⁰ Therefore, to avoid this loss of revenue and capital, both states offer incentives, potentially causing the welfare distortions discussed above in Section IIIB. The following diagram illustrates the prisoners' dilemma states face.

Outcome: (State ₁ , State ₂)	State ₁ offers no incentives	State ₁ offers incentives
State ₂ offers no incentives	(neither experience revenue losses)	(S ₁ gets business and related benefits, S ₂ loses same)
State ₂ offers incentives	(S ₁ loses business and related benefits, S ₂ gains same)	(both experience revenue losses)

In the model, the prisoners each confess because they are unable to communicate with one another. This is not the case with states, which can theoretically communicate easily with one another. However, states have been unable to enforce an agreement among themselves that forbid granting relocation incentives.⁸¹ The failure of the states in forming binding agreements prohibiting relocation incentives effectively leaves the states in the same position as the prisoners. Without the ability to execute a binding agreement against incentives with other states, a state is forced to enact incentives to ensure its economic and political position relative to its neighbors.⁸² The model predicts that a state will choose a less desirable

⁷⁹ See Taylor, *supra* note 10, at 693; see also Schaefer, *supra* note 4, at 311. Schaefer agrees that "each state would be better off not offering investment attraction subsidies (i.e. 'remaining silent') with *one small qualification*" (emphasis added). "[I]n a situation in which two states are bidding against one another, the state with the greater externalities should be allowed to be the sole bidder and then only to the extent of the externality difference. However, since externalities may be difficult to measure and in many cases there may not be significant differences between states in terms of externalities associated with an attracted enterprise, this qualification is not so large." *Id.*

⁸⁰ See *id.*

⁸¹ See Taylor, *supra* note 10, at 693 (citing Chris Christoff, *Engler Pushes for States to End Fights over Business*, DETROIT FREE PRESS, Aug. 5, 1992, at 2E ("observing that state governments are under political pressure to take action to attract new jobs and noting that incentives are seen as a way to do this." Taylor, n.10).

⁸² See Enrich, *supra* note 2, at 396-97.

outcome in order to protect itself from losing potential business to neighboring states.

B. Differing National Treatments of State Relocation Incentives

State relocation incentives are of concern to nations and trade regions around the world.⁸³ Attempts to address these relocation incentives have varied according the economic and political structures of the specific nation or region. Examining different national policies toward relocation incentives reveals different strategies in balancing the value of local authority with the economic well being of the nation. A particularly useful comparison can be made between the United States treatment of relocation incentives, which has been judicial, and the recent attempt by Canada to address incentives with an interprovincial internal trade agreement.

1. Relocation Incentives in the United States

The Constitution of the United States specifically enumerates Congress with the power “[t]o regulate Commerce with foreign Nations, and among the several States...”⁸⁴ This Commerce Clause was intended to create a free trade area within the borders of the United States,⁸⁵ and to rid the nation of the economic competition between states present during the time of the Articles of Confederation.⁸⁶ From its very beginning, Commerce Clause jurisprudence has construed the term “commerce” expansively,⁸⁷ and the Court has held that Congress may regulate channels of commerce, instruments of commerce, and activities substantially related to interstate commerce.⁸⁸

⁸³ See generally Schaefer, *supra* note 4, at 323-35 (comparing the treatment of relocation incentives by the United States, Canada, the European Community, and the WTO).

⁸⁴ U.S. CONST. art. I., § 8, cl. 3.

⁸⁵ See Little, *supra* note 75, at 864 (citing *Great Atlantic & Pacific Tea Co., Inc. v. Cottrell*, 424 U.S. 366 (1976); *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 523 (1935) (recognizing “that the peoples of the several states must sink or swim together, and that in the long run prosperity and salvation are in union and not division”)).

⁸⁶ See Enrich, *supra* note 2, at 422-23.

⁸⁷ See Little, *supra* note 75, at 864 (citing Phillip M. Tatarowicz & Rebecca F. Mims-Varlarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 VAND. L. REV. 879, 887 (1986), *citing* *Gibbons v. Ogden*, 22 U.S. 189 (1824)) (holding that “[c]ommerce, undoubtedly, is traffic, but it is something more: it is intercourse. It describes the commercial intercourse between nations, and parts of nations, in all its branches.” *Id.* at 189-90).

⁸⁸ *United States v. Lopez*, 514 U.S. 549, 558-9 (holding that the Gun-Free Schools Act of 1994 was an unconstitutional use of the Congressional Commerce power, as possessing a firearm in a school zone did not substantially relate to interstate commerce).

The Commerce Clause also acts as a limit on state regulation of interstate commerce. Under the dormant Commerce Clause, state commercial regulation is unconstitutional if it places an undue burden on interstate commerce.⁸⁹

[The Dormant Commerce Clause] prohibits economic protectionism – that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors. Thus, state statutes that clearly discriminate against interstate commerce are routinely struck down, ...unless the discrimination is demonstrably justified by a valid factor unrelated to economic protectionism.⁹⁰

Thus, states are prohibited from enacting tariffs on out-of-state products or enacting other protectionist regulations or taxes.⁹¹ Under this rationale, relocation incentives may be viewed as regulations that hinder the free trade area created by the Commerce Clause by unconstitutionally discriminating against out-of-state interests.⁹²

In addressing relocation incentives, the Supreme Court has issued decisions wrought with tension between two guiding principles.⁹³ First, the Court has repeatedly declared that States are free to use their tax systems and subsidization of industry to encourage economic growth.⁹⁴ Second, the Court has struck down state tax measures and subsidization designed to

⁸⁹ See ERWIN CHEMERINSKY, CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES, 282-83 (1997).

⁹⁰ *New Energy Company of Indiana v. Limbach*, 486 U.S. 269, 273-4 (1988).

⁹¹ See Schaefer, *supra* note 4, at 322.

⁹² See Enrich, *supra* note 2, at 424. Professor Enrich argues that “the Commerce Clause should be understood to constrain these state business tax incentives in the same way that it constrains other measures designed to set a state’s economy apart from the nation’s. This conclusion derives powerful support from an understanding of the origins and historical function of the Commerce Clause as a bulwark for an open national economy. It also follows directly from a substantial body of modern Supreme Court case law, which applies the Commerce Clause as a prohibition against a range of state tax provisions that discriminate against interstate commerce.” *Id.*

⁹³ See Hellerstein & Coenen, *supra* note 16, at 791 (recognizing “a palpable tension in the Supreme Court’s decisions); see also Enrich, *supra* note 2, at 425 (noting that “the course of the Supreme Court’s jurisprudence in this area has been tortuous”).

⁹⁴ See *id.* at 791-92 (citing *West Lynn Creamery, Inc. v. Healy*, 114 S. Ct. 2205, 2214 n.15 (1994) (holding “[d]irect subsidization of domestic industry does not ordinarily run afoul’ of the negative Commerce Clause.” (quoting *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 278 (1988))), (also citing *Boston Stock Exch. v. State Tax Comm’n*, 429 U.S. 318, 336 (1977) (declaring that the “[Court’s] decisions do [] not prevent the States from structuring their tax systems to encourage the growth and development of intrastate commerce and industry.”)).

achieve those goals on the grounds that they discriminate against out-of-state investment.⁹⁵ Commentators have struggled to distinguish constitutionally allowable relocation incentives designed to encourage economic growth from unconstitutional discriminatory relocation incentives with the same goals.⁹⁶

The Court has analyzed relocation incentives differently, depending on whether they are tax incentives, such as tax credits, exemptions or abatement, or non-tax incentives, such as cash subsidies.⁹⁷ Over the past twenty years, the Court has attempted to settle the constitutional uncertainty regarding state tax incentives.⁹⁸ However, the Court, by its own admission, has “never squarely confronted the constitutionality of subsidies....”⁹⁹ Despite the relatively small amount of case law on non-tax subsidies, it may be possible to apply the Court’s analysis of tax incentives to these non-tax incentives to determine their constitutionality.

a. Dormant Commerce Clause Limitations on Tax Incentives – Case Law

Commerce Clause jurisprudence has long prohibited state taxes that discriminate against interstate commerce,¹⁰⁰ and the Court has clearly established that a tax that imposes greater burdens on out-of-state interests than on competing in-state interests will be invalidated as a discriminatory tax under the Commerce Clause.¹⁰¹ The 1977 decision of *Complete Auto Transit v. Brady*¹⁰² set forth a four-factor test to determine whether a state

⁹⁵ See *id.*, (citing *West Lynn Creamery, Inc., v. Healy*, 114 S.Ct. 2205, at 2211-14 (1994) (striking down a Massachusetts subsidy to local dairy farms paid out of a tax on all dairy farms selling milk in Massachusetts on the grounds that it “discriminate[d] in favor of local producers.” *Id.* at 2215; also citing *Boston Stock Exch. v. State Tax Comm’n*, 429 U.S. 318, 331 (1977) (invalidating a New York statutory amendment because it “foreclose[d] tax-neutral decisions and create[d] both an advantage for the exchanges in New York and a discriminatory burden on commerce to its sister States.” *Id.*)).

⁹⁶ See *id.* at 791.

⁹⁷ See generally Schaefer, *supra* note 4, at 323-27 (evaluating the likelihood of a successful Commerce Clause challenge against tax incentives and non-tax incentives independently); see also Hellerstein & Coenen, *supra* note 16 (distinguishing the constitutional analysis of tax incentives and subsidy incentives).

⁹⁸ See Enrich, *supra* note 2, at 425.

⁹⁹ *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 199 n.15 (1994).

¹⁰⁰ See Hellerstein & Coenen, *supra* note 16, at 793 (citing *Welton v. Missouri*, 91 U.S. 275 (1875)).

¹⁰¹ See *id.*

¹⁰² *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

tax violates the dormant Commerce Clause.¹⁰³ The Court explained that its “decisions... have sustained a tax against Commerce Clause challenge when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State.”¹⁰⁴

It is the third element of the *Complete Auto* test – the anti-discrimination prong – that is of primary importance in analyzing tax incentives.¹⁰⁵ However, the Court has not given much insight into what constitutes a discriminatory tax provision.¹⁰⁶ Nonetheless, in the last twenty years, the Court has invalidated four tax provisions designed to encourage economic activity within the state.¹⁰⁷ None of these decisions has held that tax incentives are discriminatory *per se*; however, they have caused many commentators to doubt the constitutionality of all state tax incentives.¹⁰⁸ Ultimately, these decisions are essential in understanding the difficult problem of balancing economic welfare against state autonomy. In the following series of cases, the Supreme Court has recognized that states have valid reasons for enacting incentives, and may be constitutionally permitted to do so.

¹⁰³ See *id.*; see also Enrich, *supra* note 2, at 425 (explaining that “the Court in the last two decades has sought to impose some order on its dormant commerce clause analysis of state taxation by relying on the principles articulated in its 1977 decision of *Complete Auto Transit, Inc. v. Brady*.”)

¹⁰⁴ *Complete Auto Transit*, 430 U.S. at 279.

¹⁰⁵ See Enrich, *supra* note 2, at 426.

¹⁰⁶ See *id.*; see also Schaefer, *supra* note 4, at 324 (observing that “[t]here exists a degree of uncertainty over exactly which investment attraction tax incentives would run afoul of dormant Commerce Clause scrutiny.”).

¹⁰⁷ See Hellerstein & Coenen, *supra* note 16, at 794. Professors Hellerstein & Coenen examine the four recent major Supreme Court decisions which rule on state tax incentives in an effort to determine the constitutionality of other such incentives. The four decisions are *Boston Stock Exch. v. State Tax Comm’n.*, 429 U.S. 318 (1977) (invalidating a New York amendment to a New York tax providing a lower transfer tax rate on stock transfers occurring within New York), *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984) (holding that a Hawaii exemption from a state excise tax given to local alcoholic beverage producers was unconstitutionally discriminatory), *Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388 (1984) (invalidating a New York income tax credit which based the credit amount on the percentage of the taxpayer’s business conducted within New York), and *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269 (1988) (striking down an Ohio tax credit against a motor fuel tax for each gallon of ethanol sold, but only if the ethanol was produced in Ohio).

¹⁰⁸ See Hellerstein & Coenen, *supra* note 16, at 794 (noting that the Court invalidated tax incentives “with rhetoric so sweeping as to cast a constitutional cloud over all state tax incentives.”); see generally, Enrich, *supra* note 2, at 424-26 (examining the “tensions about how far the courts should delve into the empirical effects of particular tax provisions.” *Id.* at 425-26); Schaefer, *supra* note 4, at 324-26 (analyzing Hellerstein’s & Coenen’s arguments vis-à-vis Enrich’s arguments).

The first of these four decisions was *Boston Stock Exchange v. State Tax Commission*,¹⁰⁹ in which the Court considered a challenge to an amendment to a New York stock transfer tax designed to encourage the growth of the New York securities industry.¹¹⁰ Beginning in 1905, New York had collected a state transfer tax on the sale of securities occurring within the state of New York.¹¹¹ In 1968, in an effort to encourage nonresident stock sellers to complete their sales through New York brokers,¹¹² the state amended the transfer tax so that securities sales made through out-of-state brokers would be taxed at a higher rate than sales made through brokers located in New York.¹¹³

The Court unanimously struck down the amendment, finding that “[New York] violated ‘[t]he very purpose of the Commerce Clause [which] was to create an area of free trade among the several states.’”¹¹⁴ The original transfer tax “was neutral as to in-state and out-of-state sales,”¹¹⁵ imposing a burden which “fell equally on all transactions regardless of the situs of sale.”¹¹⁶ However, the 1968 amendment “upset this equilibrium,” “foreclos[ing] tax-neutral decisions and creat[ing] both an advantage for the exchanges in New York and a discriminatory burden on commerce to its sister states.”¹¹⁷ Because the amended transfer tax “impose[d] a greater tax liability on out-of-state sales than on in-state sales, ...[it] [fell] short of the substantially evenhanded treatment demanded by the Commerce Clause.”¹¹⁸ Sellers’ decisions as to where to sell securities would be influenced by their potential tax liability; sellers who wished to reduce their tax liability would be influenced to sell through a New York broker.¹¹⁹ This struck the Court as an inappropriate use of coercive power by the state,¹²⁰ which was “using its power to tax an in-state operation as a means of ‘requiring [other] business operations to be performed in the home state.’”¹²¹

¹⁰⁹ *Boston Stock Exch. v. State Tax Comm’n*, 429 U.S. 318 (1977).

¹¹⁰ See Little, *supra* note 75, at 866-67.

¹¹¹ *Boston Stock Exch.*, 429 U.S. at 319.

¹¹² See Hellerstein & Coenen, *supra* note 16, at 795.

¹¹³ See *Boston Stock Exch.*, 429 U.S. at 319.

¹¹⁴ Enrich, *supra* note 2, at 427 (quoting *Boston Stock Exch.*, 429 U.S. at 328).

¹¹⁵ *Boston Stock Exch.*, 429 U.S. at 330.

¹¹⁶ *Id.*

¹¹⁷ *Id.* at 330, 331.

¹¹⁸ *Id.* at 332.

¹¹⁹ See Hellerstein & Coenen, *supra* note 16 at 795.

¹²⁰ See *id.*

¹²¹ *Boston Stock Exch.*, 429 U.S. at 336 (quoting *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 145 (1970)).

Tax incentives, by their very design, strive to “foreclose tax-neutral decisions” by influencing corporate location decisions with potential tax liability.¹²² It has been observed that the Court’s ruling in *Boston Stock Exchange* could therefore be read to invalidate all state tax incentives.¹²³ However, the Court specifically limited its holding to the specific tax amendment challenged,¹²⁴ noting that the decision “does not prevent the States from structuring their tax systems to encourage the growth and development of intrastate commerce and industry.”¹²⁵ The Court continued, “[n]or do we hold that a State may not compete with other States for a share of interstate commerce; such competition lies at the heart of a free trade policy.”¹²⁶ While the Court clearly upheld the right of States to use their tax systems to encourage local economic growth, it did not explain how a State could structure a tax incentive under the ruling of *Boston Stock Exchange*.¹²⁷

The next major Court decision on state tax incentives was *Westinghouse Electric Corp. v. Tully*,¹²⁸ which considered the constitutionality of a New York state franchise tax credit. In 1971, as an incentive for “U.S. firms to increase their exports,”¹²⁹ Congress gave a special income tax exemption to a new corporate entity called a Domestic International Sales Corporation (DISC).¹³⁰ This change in the federal tax code was a cause for concern for the state of New York. If it followed the example of Congress and exempted all DISC income from being taxable, the state stood to lose between \$20 and \$30 million every year.¹³¹ On the other hand, the state was concerned that state taxation of DISC income would drive qualified DISCs out of the state.¹³²

As a compromise between these two interests, the New York legislature enacted tax legislation that took three steps in determining the tax liability of DISCs within New York.¹³³ The first step was to combine a

¹²² Hellerstein & Coenen, *supra* note 16, at 795 (quoting *Boston Stock Exch.*, 429 U.S. at 331).

¹²³ *See id.*

¹²⁴ *See Little, supra* note 75, at 867.

¹²⁵ *Boston Stock Exch.*, 429 U.S. at 336.

¹²⁶ *Id.* at 336-37.

¹²⁷ *See Hellerstein & Coenen, supra* note 16, at 796.

¹²⁸ *Westinghouse Electric Corp. v. Tully*, 466 U.S. 388 (1984).

¹²⁹ *Id.* at 390 (quoting H.R. REP. NO. 92-533, at 9 (1971), *reprinted* in 1971 U.S.C.C.A.N. 1825, 1827; S. REP. NO. 92-437, at 12 (1971), *reprinted* in 1971 U.S.C.C.A.N. 1918, 1922.)

¹³⁰ *See id.*; *see also* 26 U.S.C. §§ 991-997. 26 U.S.C. §§ 992(a), 993 define a corporation as a DISC if more than 95% of its gross receipts and its assets are export-related.

¹³¹ *See Westinghouse Electric*, 466 U.S. at 392.

¹³² *See id.* at 392-93.

¹³³ *See N.Y. TAX LAW* §§ 208-219-a (McKinney 2000).

DISC's income with that of its parent company.¹³⁴ Next, New York granted a tax credit for the DISC income, lowering the tax rate on DISC income to 30% of the original rate.¹³⁵ Finally, and most importantly, the DISC was limited by the DISC's "New York export ratio," which reflected the ratio of the DISC's export receipts derived from activity within New York to the DISC's total export receipts.¹³⁶ The resulting effect was that when a DISC increased its amount of export activity within New York, it received a larger tax credit – and a lower tax rate – on its income. Conversely, when a DISC moved export activity outside of New York, its tax credit for DISC income would be limited, and the tax rate would be higher.

It was this third step – the limiting of the tax credit to reflect the DISC's export ratio – which caused the Court to invalidate the tax.¹³⁷ New York argued that "multiplying the allowable credit by the New York export ratio of the DISC merely ensures that the State is not allowing a parent corporation to claim a tax credit with respect to DISC income that is not taxable by the State of New York."¹³⁸ The Court rejected this argument, though, finding that "the percentage of the DISC's accumulated income that is subject to New York franchise tax is determined by the parent's business allocation percentage, not by the export ratio."¹³⁹ The procedure for calculating the maximum allowable DISC credit

alleviates the State's fears that it will be overly generous with its tax credit, for once the adjustment of multiplying the allowable DISC export credit by the parent's business allocation percentage has been accomplished, the tax credit has been fairly apportioned to apply only to the amount of the accumulated DISC income taxable to New York.¹⁴⁰

In the Court's view, the additional credit limitation to reflect the New York export ratio was both "inaccurate and duplicative."¹⁴¹

Relying heavily on *Boston Stock Exchange*,¹⁴² the Court found that the New York tax placed a discriminatory burden on out-of-state interests.

¹³⁴ See *id.* at § 208.9(i)(B).

¹³⁵ See *id.* at § 210.3(a).

¹³⁶ *Westinghouse Electric*, 466 U.S. at 393-94.

¹³⁷ See *Hellerstein & Coenen*, *supra* note 16, at 798.

¹³⁸ *Westinghouse Electric*, 466 U.S. at 399.

¹³⁹ *Id.*

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² See *Enrich*, *supra* note 2, at 429 (noting that the Court was "[d]rawing heavily on *Boston Stock Exchange*..." *Id.*); see also *Little*, *supra* note 75 at 870 (noting that the Court

The Court held that "[w]hether the discriminatory tax diverts new business into the State or merely prevents current business being diverted elsewhere, it is still a discriminatory tax that 'forecloses tax-neutral decisions.'" ¹⁴³ In its effort to encourage local economic growth, New York had placed a discriminatory burden on interstate commerce. ¹⁴⁴

The New York tax scheme had one additional feature that was unique in the Court's tax incentive cases, one that the Court found particularly troubling. ¹⁴⁵ Whereas other tax credits ¹⁴⁶ varied only with the amount of activity in the taxing state, the New York DISC credit also varied if the amount of activity in New York remained the same, but increased outside of New York. Put another way, if a parent corporation kept its DISC activity in New York constant, and also increased it in other states, its New York DISC credit would be reduced because the DISC activity in New York would represent a smaller percentage of the company's total DISC activity. ¹⁴⁷ The Court explained, "not only does the New York tax scheme 'provide a positive incentive for increased business activity in New York State,' but also it [*sic*] penalizes increases in the DISC's shipping activities in other States." ¹⁴⁸

The third major Supreme Court decision on state tax incentives was *Bacchus Imports, Ltd. v. Dias*. ¹⁴⁹ *Bacchus Imports* concerned an exemption from Hawaii's tax on liquor sales for two locally produced alcoholic beverages. The exemption was specifically designed to "aid Hawaiian industry." ¹⁵⁰ The Court held that the Hawaii tax exemption had a "clearly

was "relying on *Boston Stock Exchange*..."); see also Hellerstein & Coenen *supra* note 16, at 800 (commenting that the Court "found that New York's effort to encourage export activity in the state suffered from constitutional infirmities similar to those that had disabled New York's earlier effort to encourage brokerage activity in the state.").

¹⁴³ *Westinghouse Electric*, 466 U.S. at 406 (quoting *Boston Stock Exch. v. State Tax Comm'n.*, 429 U.S. 318, 331) (omission in *Westinghouse Electric*, 466 U.S. at 406).

¹⁴⁴ See *id.*

¹⁴⁵ See Hellerstein & Coenen, *supra* note 16, at 801.

¹⁴⁶ See, e.g., *Boston Stock Exch. v. State Tax Comm'n.*, 429 U.S. 318 (1977); see also, e.g., *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984).

¹⁴⁷ See *Westinghouse Electric*, 466 U.S. at 400.

¹⁴⁸ *Id.* at 401 (quoting New York State Division of the Budget, Report on A. 12108-A and S.10544, at 18 (May 23, 1972)).

¹⁴⁹ *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984).

¹⁵⁰ *Id.* at 271. Hawaii created excise tax exemptions for two locally-produced beverages: one, an indigenous Hawaiian brandy; two, pineapple wine. The legislative history of the tax indicates that the brandy was exempted "to 'encourage and promote the establishment of a new industry.'" *Id.* at 270 (quoting S.L.H. 1960, c. 26, Sen. Stand. Comm. Rep. No. 87, in 1960 Senate Journal at 224). Similarly, the pineapple wine was exempted from the excise tax "to help ... the local fruit wine industry." *Bacchus Imports*, 468 U.S. at 270 (quoting S.L.H. 1976, c. 39, Sen. Stand. Comm. Rep. No. 408-76, in 1976 Senate Journal, at 1056).

discriminatory” effect because “it applie[d] only to locally produced beverages....”¹⁵¹ It was irrelevant that Hawaii’s purpose was to help local producers and not to harm out-of-state producers.¹⁵²

While the Court recognized that “a State may enact laws pursuant to its police powers that have the purpose and effect of encouraging domestic industry,” the Commerce Clause prohibits such encouragement with tax structures that favor in-state over out-of-state products.¹⁵³ However, the Court offered no suggestions as to how a state might lawfully encourage domestic industry, and gave no new insight into the limits of the Commerce Clause prohibition.¹⁵⁴

The final major Supreme Court decision dealing with tax incentives is *New Energy Company of Indiana v. Limbach*,¹⁵⁵ which dealt with an Ohio tax credit for local producers of ethanol.¹⁵⁶ Largely produced from corn, ethanol is blended with gasoline in the production of an automotive fuel called gasohol.¹⁵⁷ Beginning in 1981, Ohio offered a sales tax credit to gasohol dealers for each gallon of ethanol used in their product, regardless of the ethanol’s source.¹⁵⁸ However, in 1984, Ohio limited the tax credit to ethanol originating in Ohio or in a state that offered a similar exemption to Ohio ethanol.¹⁵⁹

The Court pointed out that “[t]he Ohio provision at issue here explicitly deprives certain products of generally available beneficial tax treatment because they are made in certain other States, and thus on its face appears to violate the cardinal requirement of nondiscrimination.”¹⁶⁰ Ohio argued that the availability of the credit to ethanol producers in states offering similar credits to Ohio ethanol producers “[was] likely to promote [interstate commerce], by encouraging other States to enact similar tax advantages that will spur the interstate sale of ethanol.”¹⁶¹ The Court quickly dismissed this, explaining that a state “may not use the threat of

¹⁵¹ Little, *supra* note 75, at 868 (quoting *Bacchus Imports*, 468 U.S. at 271).

¹⁵² See *Bacchus Imports Ltd.*, 468 U.S. at 273.

¹⁵³ Hellerstein & Coenen, *supra* note 16, at 797 (quoting *Bacchus Imports*, 468 U.S. at 271).

¹⁵⁴ See *id.*

¹⁵⁵ *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269 (1988).

¹⁵⁶ See *id.* at 271.

¹⁵⁷ See *id.*

¹⁵⁸ See *id.* at 272 (citing Act of June 10, 1981, § 1, 1981-2 Ohio Leg. Acts 1693, 1731-1732).

¹⁵⁹ See *New Energy Co.*, 486 U.S. at 272 (citing Ohio Rev. Code Ann. § 5735.145(B) (1986)).

¹⁶⁰ *New Energy Co.*, 486 U.S. at 274.

¹⁶¹ *Id.*

economic isolation as a weapon to force sister States to enter into even a desirable reciprocity agreement.”¹⁶²

Ohio pointed out that the appellant, an Indiana ethanol producer, was eligible to receive an Indiana cash subsidy for local ethanol producers.¹⁶³ The Indiana subsidy program, Ohio argued, was “no less discriminatory” than the Ohio tax credit, and “no less effective in conferring a commercial advantage over out-of-state competitors.”¹⁶⁴ The Court dismissed this argument, noting, “[t]he Commerce Clause does not prohibit all state action designed to give its residents an advantage in the marketplace, but only action of that description in connection with the State’s regulation of interstate commerce.”¹⁶⁵ Reiterating the principles of *Boston Stock Exchange*,¹⁶⁶ the Court held that “[d]irect subsidization of domestic industry does not ordinarily run afoul of [the Commerce Clause] prohibition; discriminatory taxation of out-of-state manufacturers does.”¹⁶⁷

b. Dormant Commerce Clause Limitations on Tax Incentives – Analysis

The Court’s decisions give some guidance as to the constitutionality of investment attraction tax incentives; however, they do not remove all uncertainty as to the future of such incentives.¹⁶⁸ The Court’s decisions indicate that a state may not enact a tax that discriminates against out-of-state interests in an attempt to encourage growth of local industry.¹⁶⁹ Nonetheless, it is unclear how the Court may treat a number of typical state tax incentives used to attract out-of-state investment. The Court’s language suggests that all state tax incentive programs may be found unconstitutional;¹⁷⁰ however, commentators have suggested that the

¹⁶² *Id.* (quoting *Great Atlantic & Pacific Tea Co. v. Cottrell*, 424 U.S. 366 (1976) (invalidating a Mississippi regulation which allowed out-of-state milk to be sold in Mississippi only if the producing state accepted Mississippi milk reciprocally)).

¹⁶³ *See New Energy Co.*, 486 U.S. at 277.

¹⁶⁴ *Id.*

¹⁶⁵ *Id.* at 278.

¹⁶⁶ *See Boston Stock Exch. v. State Tax Comm’n*, 429 U.S. 318, 336 (1977) (declaring that the Court decisions “[d]o not prevent the States from structuring their tax systems to encourage the growth and development of intrastate commerce and industry.” *Id.*).

¹⁶⁷ *New Energy Co.*, 486 U.S. at 278.

¹⁶⁸ *See Schaefer, supra* note 4, at 324; *see also Hellerstein & Coenen, supra* note 16, at 802.

¹⁶⁹ *See Schaefer, supra* note 4, at 324 (citing *Bacchus Imports v. Dias*, 468 U.S. 263 (1984)).

¹⁷⁰ *See Hellerstein & Coenen, supra* note 16, at 802.

Court is likely to take a more restrained approach, focusing on specific factors in tax incentives that render them unconstitutional.¹⁷¹

If one is to apply the four major Supreme Court decisions concerning state tax incentives at their broadest, one could reach the conclusion that all such incentives are unconstitutional.¹⁷² In *Boston Stock Exchange*, the Court invalidated the New York tax because it eliminated the “tax-neutral decisions” investors made when choosing a broker.¹⁷³ This holding could potentially invalidate all state tax incentives, as tax incentives are designed purposely to eliminate “tax-neutral decisions” in convincing out-of-state investment to relocate in their state.¹⁷⁴ However, the wide-sweeping implications of interpreting the Court’s decisions so broadly suggests that the Court may follow a more restrained approach.¹⁷⁵

Keeping this restrained approach in mind, commentators have suggested two sets of criteria that the Court may use in evaluating tax incentives.¹⁷⁶ Professors Hellerstein and Coenen suggest that the Court will

¹⁷¹ See Schaefer, *supra* note 4, at 324-26 (comparing the arguments of Professors Hellerstein & Coenen to the arguments of Professor Enrich to demonstrate differing opinions on the Court’s view of tax incentives); see also Enrich, *supra* note 2, at 432-33 (attempting to draw specific lessons from the Court’s decisions); see generally Hellerstein & Coenen, *supra* note 16, at 802-15 (comparing broad and restrained interpretations of the Court’s decisions).

¹⁷² See Hellerstein & Coenen, *supra* note 16, at 802 (noting that “[a] literalistic focus on key passages in the Court’s opinions might suggest that ‘all state inducement programs are likely to be unconstitutional.’” (quoting William J. Barrett VII, Note, *Problems with State Aid to New or Expanding Businesses*, 58 S. CAL. L. REV. 1019, 1049 (1985))).

¹⁷³ *Boston Stock Exch.*, 429 U.S. at 331.

¹⁷⁴ See Hellerstein & Coenen, *supra* note 16, at 802 (quoting *Boston Stock Exch.*, 429 U.S. at 331).

¹⁷⁵ See *id.* at 804. Professors Hellerstein and Coenen point out that virtually no state income tax incentive satisfies the Court’s requirement of “strict geographic neutrality.” *Id.* at 802. For example, Alabama provides an income tax credit for new investment in Alabama; Colorado provides an income tax credit for purchasing qualifying property in Colorado. *Id.* at 802-3. All of these income tax incentives provide “a tax benefit for in-state investment that is not available for identical out-of-state investment,” and “skew a taxpayer’s decision in favor of the former.” *Id.* at 803. The same analysis applies to state sales and property tax incentives designed to encourage local investment. *Id.* All tax incentives, therefore, may potentially be attacked as violations of the Commerce Clause by “inducing resources to be allocated among the states on the basis of tax criteria.” *Id.* at 804.

While Hellerstein & Coenen recognize that the Court “revealed a willingness to subject a wide array of fiscal measures to exacting scrutiny, striking down sales, income, and transaction taxes” with “an extraordinary degree of consensus,” and without “a single dissent on the merits of the Commerce Clause issue,” they believe that the Court’s “opinions can and should be read less expansively than their literal language permits.” *Id.* at 804-5.

¹⁷⁶ See Enrich, *supra* note 2, at 448-58; see also Hellerstein & Coenen, *supra* note 16, at 806.

strike down a state tax incentive if it favors in-state activity over out-of-state activity, while using the coercive power of state taxation.¹⁷⁷ All four of the Court's tax incentive decisions satisfy these criteria, and all four were struck down.¹⁷⁸

This test would invalidate many state tax incentives; however, one significant category of tax incentives designed to encourage investment will stand unscathed: tax incentives which are not exemptions from or reductions of a taxpayer's existing tax liability, but which are exemptions or reductions from the tax liability that would result if the taxpayer engaged in the targeted activity in the state.¹⁷⁹ Under the Hellerstein and Coenen test, income tax credits given for in-state investment would remain invalid, but property tax abatements and sales tax exemptions given to new in-state investment would be valid.¹⁸⁰ Whereas income tax credits would be invalid because they favor in-state activity over out-of-state activity and involve the coercive power of the state,¹⁸¹ property and sales tax exemptions "are valid since the state is merely 'disclaiming the right to impose any taxes on a "virgin" tax base the state is seeking to attract.'"¹⁸²

Such a property tax or sales tax exemption shows no favoritism for local over out-of-state interests, and does not rely on the coercive power of the state in attracting new investment.¹⁸³ To illustrate this distinction, Professors Hellerstein and Coenen characterize the exempting state's position as saying:

¹⁷⁷ See Hellerstein & Coenen, *supra* note 16, at 806.

¹⁷⁸ See *id.* *Boston Stock Exchange* favored in-state over out-of-state sales; the *Bacchus Imports and New Energy Co.* tax incentives favored in-state production over out-of-state production; and *Westinghouse Electric* favored exportation occurring in-state over that occurring out-of-state. Additionally, the state used its power of taxation to force in-state investment: in *Boston Stock Exchange*, taxpayers would face higher transfer taxes unless they used in-state brokers; in *Bacchus Imports and New Energy Co.*, taxpayers would pay higher taxes on liquor and fuel unless they supported local products; in *Westinghouse Electric*, taxpayers would have a greater tax liability unless they increased their export activity within the taxing state. See *id.*

¹⁷⁹ See *id.* at 806-7.

¹⁸⁰ See Schaefer, *supra* note 4, at 325 (citing Hellerstein & Coenen, *supra* note 16, at 816-20, 825-34).

¹⁸¹ See Hellerstein & Coenen, *supra* note 16, at 817 (explaining that such credits "implicate the coercive power of the state, because the taxpayer can reduce its state tax bill only by engaging in in-state activity").

¹⁸² Schaefer, *supra* note 4, at 325 (quoting Hellerstein & Coenen, *supra* note 16, at 809).

¹⁸³ See Hellerstein & Coenen, *supra* note 16, at 808.

Come to our state and we will not saddle you with any additional property tax burdens. Moreover, should you choose not to accept our invitation, nothing will happen to your tax bill....¹⁸⁴

This position is contrasted with the position taken by tax incentive cases the Court has confronted in the past, in which the state's position could be characterized as saying:

You are already subject to our taxing power because you engage in taxable activity in this state. If you would like to reduce your tax burdens, you may do so by directing additional business activity into this state. Should you decline our invitation, we will continue to exert our taxing power over you as before, and your tax bill might even go up.¹⁸⁵

This example demonstrates how the tax incentive provisions invalidated by the Court utilized the coercive power of the state to encourage development in-state.

Professor Enrich has suggested that a different set of criteria should be used when evaluating Commerce Clause challenges to state tax incentives.¹⁸⁶ Instead of the state-favoritism/state-coercion test that Hellerstein and Coenen suggest, Enrich believes that the Court's primary focus in evaluating a state tax incentive and whether it violates the antidiscrimination principle has been "a practically oriented analysis of the provision's purposes and effects."¹⁸⁷ Tax provisions designed to give an advantage to local activity over competing out-of-state activity evidence discrimination, and the Court has struck such provisions down for "discriminat[ing]... by 'providing a direct commercial advantage to local business.'"¹⁸⁸

Because the Commerce Clause was intended to minimize trade distortions and economic competition between the states,¹⁸⁹ Enrich argues that the proper test for evaluating tax incentives "should be whether a particular tax provision distorts economic decision-making in favor of in-state activity, not whether it treats in-state and out-of-state actors disparately."¹⁹⁰ This proposed test is a stricter standard than the criteria

¹⁸⁴ *Id.*

¹⁸⁵ *Id.*

¹⁸⁶ See Enrich, *supra* note 2, at 432-33.

¹⁸⁷ *Id.* at 432.

¹⁸⁸ *Id.* (quoting *Bacchus Imports*, 468 U.S. at 268).

¹⁸⁹ See Schaefer, *supra* note 4, at 325.

¹⁹⁰ Enrich, *supra* note 2, at 456.

proposed by Hellerstein and Coenen.¹⁹¹ If the Court did evaluate a tax incentive on whether it distorted economic decision making towards the taxing state, then the same property tax that was constitutional under Hellerstein and Coenen's state-favoritism/state-coercion test will be struck down.¹⁹²

Keeping the Commerce Clause values of economic union and federalism in mind, Enrich argues that "the Court has the opportunity to strengthen its Commerce Clause jurisprudence" by "prohibit[ing] state tax measures that discriminate against interstate commerce by distorting the decisions of economic actors in favor of expenditures on in-state activities."¹⁹³ This prohibition would render all state tax incentives "virtually per se unconstitutional," even those that would pass constitutional muster under the Hellerstein and Coenen test.¹⁹⁴

Two points should be taken from the Court's decisions on state tax incentives. First, the Court has not yet squarely decided the constitutionality of tax incentives designed to attract investment to the state. Second, the Court's decisions reflect an interest in balancing the economic welfare of the nation with the local autonomy of the states. In recognizing the state's interest encouraging development with autonomy, the Court implicitly recognizes that there are valid reasons for a state to enact incentives, a point that the prisoners' dilemma model can fail to fully capture.

c. Dormant Commerce Clause Limitations on Non-Tax Incentives – Case Law

While the Court has invalidated all of the state tax incentive provisions it has had occasion to consider, non-tax incentives (subsidies) have had a greater record of success. This has caused considerable confusion, as the practical effect of a cash subsidy given to a business is the same as the effect of a tax credit of the same amount.¹⁹⁵ This is of particular note because the Court has said that "'constitutionality under the commerce Clause ... depends upon ... practical effect' and 'economic

¹⁹¹ See Schaefer, *supra* note 4, at 326.

¹⁹² See *id.*

¹⁹³ Enrich, *supra* note 2, at 457-58.

¹⁹⁴ *Id.* at 458.

¹⁹⁵ See Hellerstein & Coenen, *supra* note 16, at 835 (noting that "[e]conomists know that the real-world impact of such a subsidy mirrors the effect of the [tax] credit" *Id.* (citing HEILBRONER & THUROW, *supra* note 16, at 173)).

realities.”¹⁹⁶ While the Court has “never squarely confronted the constitutionality of subsidies,”¹⁹⁷ examining its treatment of non-tax subsidies provides insight into whether state subsidization of local activity is permissible under the Commerce Clause.

In 1976, the Supreme Court heard the case of *Hughes v. Alexandria Scrap Corporation*,¹⁹⁸ which dealt with Maryland’s subsidy program for the processing of abandoned automobiles. In an effort to rid their state of abandoned automobiles, the Maryland legislature enacted a complicated subsidy structure that penalized storage of abandoned automobiles with fines, while rewarding the processing of these automobiles with cash bounties.¹⁹⁹ Collecting the processing bounties required submission of detailed documentation; however, the state’s documentation requirements were less stringent for in-state processors.²⁰⁰ Out-of-state car processors challenged the subsidy, arguing that it “violated the Commerce Clause by interfering with ... the flow of bounty-eligible hulks across state lines.”²⁰¹

The Court upheld the subsidy program, holding that “[n]othing in the purposes animating the Commerce Clause prohibits a State ... from participating in the market and exercising the right to favor its own citizens over others.”²⁰² In a concurring opinion, Justice Stevens noted that the Commerce Clause does not “inhibit a State’s power to experiment with different methods of encouraging local industry,” be it with a “cash subsidy, a tax credit, or a special privilege intended to attract investment capital.”²⁰³ Such activity, Stevens wrote, “should note [*sic*] be characterized as a ‘burden’ on commerce.”²⁰⁴

Alexandria Scrap represents the Court’s creation of the market-participation exemption from the dormant Commerce Clause. Distinguishing the Maryland auto hulk bounties from unconstitutional provisions which “interfer[e] with the natural functioning of the interstate market either through prohibition or through burdensome regulation,” the Court found that Maryland “ha[d] entered into the market itself to bid up [auto hulks’] price.”²⁰⁵ Thus, a state is exempt from dormant Commerce

¹⁹⁶ *Id.* (quoting *Department of Revenue v. Association of Wash. Stevedoring Cos.*, 435 U.S. 734, 750 (1978) and *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977)).

¹⁹⁷ *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 199 n.15 (1994).

¹⁹⁸ *Hughes v. Alexandria Scrap Corporation*, 426 U.S. 794 (1976).

¹⁹⁹ *See id.* at 796-801.

²⁰⁰ *See id.*

²⁰¹ *Id.* at 802.

²⁰² *Id.* at 810.

²⁰³ *Alexandria Scrap*, 426 U.S. at 816 (1976) (Stevens, J., *concurring*).

²⁰⁴ *Id.*

²⁰⁵ *Id.* at 806.

Clause constraints when it participates in a market, buying or selling goods, instead of regulating it.²⁰⁶

The Court has mentioned state subsidies in a number of other decisions that do not directly confront their constitutionality.²⁰⁷ First, in *New Energy Company of Indiana v. Limbach*,²⁰⁸ the Court discussed Indiana's ethanol subsidy as an alternative to Ohio's ethanol tax credit.²⁰⁹ The Court did not decide the constitutionality of the Indiana subsidy; however, it "offer[ed] its now often-cited utterance that '[d]irect subsidization of domestic industry does not ordinarily run afoul of [the Commerce Clause] prohibition.'"²¹⁰

This point was reiterated in *South-Central Timber Development, Inc. v. Wunnicke*,²¹¹ and again in *C & A Carbone, Inc. v. Town of Clarkstown*.²¹² *South-Central Timber* dealt with an Alaska provision designed to assist the in-state timber industry. While the Court did not decide the case on the constitutionality of the provision, Justice Rehnquist's dissenting opinion indicated that the subsidy should be considered valid under the market-participant exception set forth in *Alexandria Scrap*.²¹³ *C & A Carbone* invalidated a state law that required use of a local waste-processing center for all local waste. When the town argued that it was using the only means available to support the processing center,²¹⁴ the Court disagreed, saying, "the town may subsidize the facility through general taxes or municipal bonds."²¹⁵

The most recent state subsidy case heard by the Court was *West Lynn Creamery v. Healy*.²¹⁶ In response to the loss of market share experienced by local dairy farmers, Massachusetts enacted legislation that did two things.²¹⁷ First, it required every in-state dealer of milk to make a monthly payment into the Massachusetts Dairy Equalization Fund.²¹⁸

²⁰⁶ See Schaefer, *supra* note 4, at 323-24.

²⁰⁷ See generally, Hellerstein & Coenen, *supra* note 16, at 840-45 (examining the various cases in which the Court has touched on the constitutionality of state subsidies).

²⁰⁸ See *supra* notes 158-167 and accompanying text.

²⁰⁹ See *New Energy Co.* at 278.

²¹⁰ Hellerstein & Coenen, *supra* note 16, at 840 (quoting *New Energy Co.*, 486 U.S. at 278).

²¹¹ *South-Central Timber Development, Inc. v. Wunnicke*, 467 U.S. 82 (1984).

²¹² *C & A Carbone, Inc. v. Town of Clarkstown*, 511 U.S. 383 (1994).

²¹³ *South-Central Timber*, 467 U.S. at 103 (Rehnquist, J., dissenting). For a discussion of the market-participation exception, see notes 232-239 and accompanying text.

²¹⁴ See *C & A Carbone, Inc.*, 511 U.S. at 394.

²¹⁵ *Id.* at 394 (O'Connor, J., concurring).

²¹⁶ *West Lynn Creamery, Inc.*, 512 U.S. 186 (1994).

²¹⁷ See *id.* at 189.

²¹⁸ See *id.* at 190.

Second, it distributed the proceeds of the Fund to in-state milk producers.²¹⁹ The Court invalidated the measure, recognizing that its practical effect was to burden out-of-state producers with the entire cost of the subsidy, because the subsidy represented a tax rebate to in-state producers.²²⁰ This functional tax rebate was indistinguishable from the tax exemption declared unconstitutional in *Bacchus*.²²¹

However, *West Lynn Creamery* should not be read as an indication that all state subsidies of local activity are unconstitutional. The Court invalidated the Massachusetts statute on very narrow grounds, explaining that since the subsidy was funded directly from the taxes on milk produced out-of-state, the subsidy “not only assist[ed] local farmers, but burden[ed] interstate commerce.”²²² While “[a] pure subsidy funded out of general revenue ordinarily imposes no burden on interstate commerce, but merely assists local business,” the Massachusetts program “violate[d] the cardinal principle that a State may not ‘benefit in-state economic interests by burdening out-of-state competitors.’”²²³

D. Dormant Commerce Clause Limitations on Non-Tax Incentives – Analysis

The Court’s pronouncement in *West Lynn Creamery* that it has “never squarely confronted the constitutionality of subsidies” has left many scholars guessing as to the future of non-tax incentives.²²⁴ It has been argued that the line of examined cases and the market-participant exception will render state subsidies constitutional.²²⁵ Others believe that these objections fail to undermine the Commerce Clause challenge that should be levied against state subsidies.²²⁶

Beginning with *Alexandria Scrap*, and all the way through *West Lynn Creamery*, the Court reiterates two themes. First, the Court has never set forth a detailed explanation of how subsidy programs interact with the Constitution. Second, the Court believes that “[d]irect subsidization of domestic industry” is generally constitutional.²²⁷ The Court’s opinions in

²¹⁹ See *id.* at 191.

²²⁰ See *Enrich*, *supra* note 2, at 431 (citing *West Lynn Creamery*, 512 U.S. at 194).

²²¹ See *West Lynn Creamery, Inc.* 512 U.S. at 196-97.

²²² *Id.* at 199.

²²³ *Id.* (quoting *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, at 273-74 (1988)).

²²⁴ *Id.* at n.15.

²²⁵ See *Hellerstein & Coenen*, *supra* note 16, at 839-48.

²²⁶ See generally *Enrich*, *supra* note 2, at 440-48.

²²⁷ *Hellerstein & Coenen*, *supra* note 16, at 839 (quoting *New Energy Co.*, 486 U.S. at 278).

Alexandria Scrap, *South-Central Timber*, *C & A Carbone*, and *New Energy Co.* all endorse state subsidies to some degree;²²⁸ however, those endorsements usually occur in "only the briefest dicta,"²²⁹ and are applied in a very narrow scope.²³⁰

The market-participant exception to dormant Commerce Clause limitations outlined in *Alexandria Scrap* is further evidence that subsidies do not violate the dormant Commerce Clause. While the court has not applied the market-participant exception *per se* to state subsidies, the underlying rationale supports the notion that subsidies should be exempt from constitutional challenge.²³¹ The market-participant exception is based on the idea that states ought to be free to spend their resources as they see fit when conducting business activities, such as buying and selling goods.²³² The Commerce Clause does not "inhibit a State's power to experiment with different methods of encouraging local industry,"²³³ nor does it "limit the ability of the States themselves to operate in the free market."²³⁴

While the Court has never comprehensively examined state subsidies, it is likely that it will not invalidate subsidies as it has repeatedly done to state tax incentives.²³⁵ The Court has explicitly approved "subsidization of domestic industry" repeatedly,²³⁶ has recognized the market-participant exception to Commerce Clause limitations, and has exempted direct payment subsidies funded from state general treasuries.²³⁷

The Court's treatment of state subsidies requires that a distinction be made between tax incentives and subsidies, and suggests that state subsidies are largely immune from the challenges that undermine tax incentives.²³⁸ The Court's indication that a state may constitutionally develop its economy through subsidization reveals an implicit recognition of the need for state autonomy in economic development, just as was

²²⁸ See *supra* notes 199-215 and accompanying text.

²²⁹ Hellerstein & Coenen, *supra* note 16, at 843.

²³⁰ See *id.* (commenting that the Court's approval of Maryland's auto hulk subsidy program was based on the limited grounds of the market-participant exception, and that the decision in *Carbone* was based on the grounds that the subsidy represented the "least restrictive alternative for meeting a critical state financing need.").

²³¹ See *id.* at 845.

²³² Little, *supra* note 75, at 874.

²³³ *Huges v. Alexandria Scrap Corporation*, 426 U.S. 794, 816 (1976).

²³⁴ See Little, *supra* note 75, at 874 (quoting *Reeves v. Stake*, 447 U.S. 429, 437 (1980)).

²³⁵ See *id.*; see also Hellerstein & Coenen, *supra* note 16, at 844; Schaefer, *supra* note 4, at 324-25.

²³⁶ Hellerstein & Coenen, *supra* note 16, at 844 (quoting *New Energy Co. v. Limbach*, 486 U.S. at 278).

²³⁷ See Schaefer, *supra* note 4, at 324 (citing *New Energy Co.*, 486 U.S. 269 (1988)).

²³⁸ See *id.*

present in the tax incentive cases. This recognition suggests that the Court understands that a state may want to grant relocation incentives in an attempt to maximize its attractiveness to foreign investment, not merely out of fear of the economic decisions of neighboring states. By focusing only on the potential welfare distortions posed by relocation incentives, the prisoners' dilemma fails to capture the value of local autonomy in economic development recognized by the Supreme Court.

2. Relocation Incentives in Canada

There is no equivalent of the dormant Commerce Clause in the Canadian Constitution.²³⁹ To this date, the Canadian Supreme Court has not interpreted the federal trade and commerce power broadly enough to permit federal legislation over interprovincial trade matters such as relocation incentives.²⁴⁰ As a result, the provinces retain significant amounts of authority over inter-provincial trade.²⁴¹ In response to the recent push to eliminate interprovincial trade barriers, the Agreement on Internal Trade was signed in 1994 by the provinces²⁴² and designed to reduce and eliminate barriers to the free exchange of goods, services, labor, and investment within Canada.²⁴³

The Agreement on Internal Trade provides four central principles for its implementation. First, provinces will not establish new barriers to trade within Canada. Second, provinces will give equal treatment to all Canadian persons, goods, services, and investments. Third, the provinces will modify regulations as necessary to allow free trade within Canada. Finally, the provinces will ensure that provincial policies provide for free trade within Canada.²⁴⁴ These principles guide the application of its provisions.

The Agreement's general rules are laid out in Chapter Four, and they apply to the Agreement as a whole unless otherwise excepted. Article 401, which is entitled "Reciprocal Non-Discrimination," requires the provinces to provide the goods, services, persons, and investments of other

²³⁹ See Matthew Schaefer, *Searching for Pareto Gains in the Relationship Between Free Trade and Federalism: Revisiting the NAFTA, Eyeing the FTAA*, 23 CAN.-U.S. L. J. 441, 462 (1997).

²⁴⁰ See *id.* at 461.

²⁴¹ See Schaefer, *supra* note 4, at 332.

²⁴² See Schaefer, *supra* note 240, at 462.

²⁴³ See Michael J. Trebilcock & Rambod Behboodi, *The Canadian Agreement on Internal Trade: Retrospect and Prospects*, in GETTING THERE: AN ASSESSMENT OF THE AGREEMENT ON INTERNAL TRADE 20, 39-40 (Michael J. Trebilcock & Daniel Schwanen, eds., 1995).

²⁴⁴ Agreement on Internal Trade, July 18, 1994, art. 102(3), Can.

provinces “treatment no less favourable than the best treatment it accords” to those items originating within its borders.²⁴⁵ This sentiment is echoed in article 402, which forbids any province from “adopt[ing] or maintain[ing] any measure that restricts or prevents the movement of persons, goods, services or investments across provincial boundaries.”²⁴⁶

While these provisions seem stern in their prohibition of internal trade barriers, the Agreement has extensive exception provisions. Article 404 provides that any measure that is inconsistent with articles 401 or 402 may be permissible if: 1) the measure is designed to achieve a legitimate objective; 2) the measure does not unduly impair the access of persons, goods, services or investments of another province that meet the objective; 3) the measure is the least restrictive means of obtaining the objective; and 4) the measure does not disguise the restriction of trade.²⁴⁷ Article 404 demonstrates that in drafting the Agreement, the provinces retained for themselves the freedom to adopt policy measures that harm interprovincial trade, provided a legitimate objective can be shown.²⁴⁸

The same tension can be seen in the Agreement’s provisions addressing investment. Chapter Six, which covers investment, is explicitly exempt from the general rules of articles 401, 402, 403, and 404.²⁴⁹ Article 603 provides that each province must provide to an investor or an enterprise of another province “treatment no less favourable than the best treatment it accords” to investors and enterprises from within its own borders.²⁵⁰ This non-discrimination principle is applied specifically to incentives in article 607, which provides that a province may not condition an investor or enterprise’s receipt of an incentive on purchasing or using local goods or services.²⁵¹

However, just as in Chapter Four, Chapter Seven carves out specific exceptions that allow incentives inconsistent with the provisions stated above. Article 607, Paragraph 2 provides that a province will be permitted to condition the receipt of an incentive on carrying out economic activities or creating employment within the province.²⁵² Paragraph 3 permits the creation of incentives for “regional economic development purposes,” as long as the measure is the least restrictive means possible to meet the objective, and as long as other provinces are given adequate

²⁴⁵ *Id.* art. 401.

²⁴⁶ *Id.* art. 402.

²⁴⁷ *See id.* art. 404.

²⁴⁸ *See* Trebilcock & Behboodi, *supra* note 243, at 43-44.

²⁴⁹ *See* Agreement on Internal Trade, art. 600(1).

²⁵⁰ *Id.* art. 602.

²⁵¹ *See id.* art. 606(1).

²⁵² *See id.* art. 606(2).

notice.²⁵³ Finally, article 4 of Annex 607.3 (Code of Conduct on Incentives) recognizes that relocation incentives may potentially harm the economic interests of other provinces, and instructs that the provinces are to consider the economic interests of other provinces when developing their incentive policies.²⁵⁴ The provinces must “endeavour” to refrain from granting incentives that sustain economically infeasible operations for an extended period of time, create unwarranted increase in any market sectors, or are excessive in value.²⁵⁵

Just as Chapter Four, which provided the general rules for the Agreement, Chapter Six reveals the provinces’ lack of commitment to drafting an effective prohibition on internal trade barriers. The Chapter boldly prohibits discriminatory incentives in article 602, yet just as quickly provides a comprehensive list of exceptions for provinces to employ. The exceptions do have limitations, but they are flimsy. For instance, an incentive is permissible as long as it is “not more trade restrictive than necessary to achieve its specific objective.”²⁵⁶ In abiding by the provisions of Annex 608.3, a province must merely “endeavour” not to enact forbidden incentives.²⁵⁷ These terms are largely subjective, and difficult if not impossible to enforce.

It may be too early to measure the effectiveness of the 1994 Agreement on Internal Trade; however, it seems unlikely that it will succeed in removing the Canadian provinces from the prisoners’ dilemma they face.²⁵⁸ Since the Agreement leaves the determination of whether incentives are appropriate and permissible in the hands of individual provinces, no province can be sure that others will not enact incentives. The provinces are left with no choice but to grant incentives of their own, lest they risk being damaged by other provincial incentives.

IV. A NEW MODEL: WHY THE STATES MAY NOT BE TRAPPED IN THE PRISONERS’ DILEMMA

A. The Call for a Federal Legislative Solution

In an effort to save the states from the prisoners’ dilemma, many commentators have called for federal legislation to halt the further

²⁵³ *Id.* art. 606(3).

²⁵⁴ *See* Agreement on Internal Trade, Annex 607.3, art. 4.

²⁵⁵ *See id.*; *see also* Trebilcock & Behboodi, *supra* note 243, at 54.

²⁵⁶ Agreement on Internal Trade, art. 606(3)(b).

²⁵⁷ *Id.* Annex 607.3, art. 4.

²⁵⁸ *See* Schaefer, *supra* note 4, at 334.

enactment of state investment relocation incentives.²⁵⁹ The uncertain level of success the U.S. has had with Commerce Clause restraints, and Canada's mixed opinions on the Internal Trade Agreement has led some to the conclusion that federal intervention is necessary.²⁶⁰ The argument for federal restraints is based on the notion that the federal government has a greater ability to enforce restraints against incentives than local governments, thus relieving them from the prisoners' dilemma.²⁶¹

It has been argued that the federal government would enforce a ban on incentives more effectively than state governments. Federal legislation would not require unanimous consent of every state to be enacted, as would a binding agreement among states.²⁶² Federal legislation would be enforced by federal courts, which are not subject to the political pressures and distortions to which state courts are vulnerable.²⁶³ Finally, while legislation holding states accountable for misguided incentives is becoming increasingly popular, there is no guarantee that states will accurately measure economic externalities that incentives are designed to counteract.²⁶⁴ With these advantages in mind, commentators believe that federal legislation is necessary to remove the states from the prisoners' dilemma.²⁶⁵

B. The Weakness of the Prisoners' Dilemma

The prisoners' dilemma has been used extensively to describe the situation faced by the states when enacting relocation incentives.²⁶⁶ As discussed above in Section IIIC, the prisoners' dilemma suggests that even though states are best off when no incentives are enacted, states enact relocation incentives because they cannot be sure that their neighbors will

²⁵⁹ See generally Taylor, *supra* note 10, at 694-708 (describing the inadequacies of contract theory and suggesting federal-level models); Schaefer, *supra* note 4, at 335-41; Little, *supra* note 75, at 877-80.

²⁶⁰ See generally Taylor, *supra* note 10, at 694-708 (discussing possible federal models and the strengths of these models); Schaefer, *supra* note 4, at 335-41.

²⁶¹ See Taylor, *supra* note 10, at 696; see also Schaefer, *supra* note 4, at 336.

²⁶² See Schaefer, *supra* note 4, at 336.

²⁶³ See Taylor, *supra* note 10, at 695.

²⁶⁴ See Schaefer, *supra* note 4, at 336-37.

²⁶⁵ See *id.* at 335-36.

²⁶⁶ See generally Schaefer, *supra* note 4, at 335-41; Enrich, *supra* note 2, at 396-97; Little, *supra* note 75, at 858-59; Taylor, *supra* note 10, at 693-94 (recognizing the need for cooperation between the states to cease offering relocation incentives).

not.²⁶⁷ However, careful examination of the model's structure shows that it does not tell the full story.

The prisoners' dilemma is a model that attempts to explain decisions parties make based on certain known consequences for those decisions. The results the model predicts are entirely dependent upon the way in which the model is set up. In other words, the person who sets up the model can drastically affect the outcome predicted depending on the sentences imposed for the prisoners' different choices.

Below is the diagram of the prisoners' dilemma as set up by Professor Schaefer:

Outcome is (P ₁ 's sentence, P ₂ 's sentence)	P ₁ doesn't confess	P ₁ confesses
P ₂ doesn't confess	(0 years, 0 years)	(1 year, 10 years)
P ₂ confesses	(10 years, 1 years)	(5 years, 5 years)

As described above, the prisoner chooses to confess because he is afraid of the ten-year sentence that will be imposed if his companion confesses but he does not.²⁶⁸ However, if the model assumes different consequence valuations, the outcome will be different. For example, if the model is changed by changing the ten-year penalty sentence for not confessing to a five-year maximum sentence, the prisoner will make a different choice. Consider the following diagram:

Outcome is (P ₁ 's sentence, P ₂ 's sentence)	P ₁ doesn't confess	P ₁ confesses
P ₂ doesn't confess	(0 years, 0 years)	(1 year, 5 years)
P ₂ confesses	(5 years, 1 years)	(5 years, 5 years)

In this situation, a prisoner who does not confess is no worse off than one who does. The prisoner who confesses will receive one year if the other remains silent, and will receive a sentence of five years if the other confesses. A prisoner who remains silent will go free if the other remains silent, and five years if the other confesses. With these sentencing parameters, there is no fear of incurring a heavy sentence for not confessing, and thus no reason for a prisoner to confess.

The literature on state relocation incentives and the prisoners' dilemma fails to address the malleable nature of the model. While the model articulated by Schaefer and used by others succeeds in explaining

²⁶⁷ See *supra* notes 75-82 and accompanying text.

²⁶⁸ See *supra* notes 77-78 and accompanying text.

why a state that does not want to grant relocation incentives might feel compelled to do so, it does not examine the circumstances under which a state may find granting incentives desirable.

In order to understand the reasons why a state may believe granting incentives is beneficial, one should turn to the prisoners' dilemma model often used by economists. Consider the following description of the model:

Two criminals have been caught by the police. Because of the lack of evidence, the prosecution needs a confession to convict. If no confession ensues, they will be charged and convicted for a minor offense earning them one year less than a conviction for the main crime.

The prosecutor offers each prisoner the following deal. If she confesses, and the other does not, she will get three years off her sentence whereas the other prisoner will get an extra year in prison. If both confess, they will be punished according to the law (no reductions).²⁶⁹

Eichberger's model is diagramed as follows:

Outcome is (P ₁ 's sentence, P ₂ 's sentence')	P ₁ doesn't confess	P ₁ confesses
P ₂ doesn't confess	(main crime minus 1 year, main crime minus 1 year)	(main crime minus 3 years, main crime plus 1 year)
P ₂ confesses	(main crime plus 1 year, main crime minus 3 years)	(main crime, main crime)

At first glance, Eichberger's sentences may appear to offer no additional insight into the model. It is true that just as under Schaefer's penalty structure, the prisoners both confess, leaving them with an outcome other than their ideal. However, there is an important distinction to be made.

In Schaefer's model, the best outcome a prisoner can hope for is zero years in prison, which occurs when both prisoners remain silent. Compare this to Eichberger's economic game theory model, in which a prisoner's ideal outcome is having three years removed from his sentence. This outcome occurs if he confesses and his cohort remains silent. One may wonder what difference this makes. After all, both models predict that the prisoners will both confess, thus leaving them with unwanted outcomes.

²⁶⁹ JURGEN EICHBERGER, *GAME THEORY FOR ECONOMISTS* 65 (1993); *see also* MARTIN J. OSBORNE & ARIEL RUBINSTEIN, *A COURSE IN GAME THEORY*, 16-17 (1994) (articulating a model of the prisoners' dilemma which imposes the same sentence values as Eichberger's model).

The difference between the models lies not in the outcomes, but in the motivations the prisoners have for the choices they make.

In Schaefer's model, the prisoners' desired outcome is zero years in prison, which they can only reach if they both remain silent. However, they have no way of knowing if the other has remained silent or has confessed. Because the prisoner *fears* the ten-year sentence he will be handed if he remains silent and the other has confessed, he chooses to confess. This is crucial, and bears repeating. Each prisoner gives up hope of achieving his preferred outcome because he is afraid of what the other might do. Thus, the prisoner's choice is made with a defensive posture; that is, he is trying to protect himself.

Under Eichberger's economic game theory model, the prisoners have different motivations for making their choices. With the sentences used in Eichberger's model, the prisoner's preferred outcome is three years less than a conviction for the major crime imposes. The prisoner will receive this sentence if he confesses and the other prisoner remains silent. The prisoner confesses because it is necessary for him to do so to reach his ultimate goal. He confesses not in a defensive posture, and not out of fear as in Schaefer's model, but in an aggressive move designed to attain his desired outcome.

The motivations of the prisoners in both models can be contrasted in another way. In Schaefer's model, the prisoner makes the choice to confess, as illustrated by the following imagined inner monologue: "I am best off if we both remain silent. I can't be sure that the other prisoner will remain silent, and I do not want to risk going to prison for ten years, so I am going to confess. Even though I'm giving up on my preferred outcome, I will be better off than if the other prisoner confesses and I remain silent." This reasoning is entirely defensive in nature, as becomes even clearer when contrasted with Eichberger's prisoner's thoughts: "I am best off if I confess and the other prisoner does not. I am going to confess to give myself the best chance I can to reach my desired outcome. I cannot control the other prisoner's choice, but I will do what I can to advance my interests."

It may seem that this is an intellectual exercise without much meaning. After all, under both models, the prisoners both confess, and both receive larger sentences than they would have received had they both remained silent. The crucial distinction is the divergence of interest and choice in Schaefer's model, contrasted with the convergence of interest and choice in Eichberger's. In Schaefer's model, each prisoner chooses to confess, even when it is in his best interest to remain silent. However, in Eichberger's model, the prisoner is acting in furtherance of his interests when he confesses. This may be of little consequence for the prisoners, who have to serve jail time in both models. The distinction has considerable value, however, when applied to the study of state investment relocation incentives.

Both models presume that the prisoners make their decisions simultaneously, or at least that the sentences are imposed simultaneously. This means that timing is not a concern to the prisoners. A prisoner does not benefit from acting first. If one prisoner chooses to confess, his sentence is not imposed until the other prisoner makes his decision. This is not the case with states. If a state chooses to grant an incentive before any of its neighbors, it is likely to gain a timing advantage over those neighbors. Even if a neighboring state decides to match the incentive with one of their own, the timing advantage gained by the state that acts first may preserve the incentive's benefits.

This point illustrates the inaccuracy of Schaefer's model in analyzing the motivations states have when enacting relocation incentives. As was discussed earlier, in Schaefer's model, states enact incentives out of an underlying fear that they will be penalized if they do not. They enact incentives *defensively*, to protect themselves against the incentives other states might enact. I do not believe that this model portrays state goals as accurately as Eichberger's model.

Eichberger's model describes the states' actions as aggressive attempts to maximize their advantage over their neighbors in attracting outside investment. The states make incentive decisions in a context of economic factors that are constantly shifting. Enacting an incentive may be the factor that gives a state the necessary advantage over its neighbors to attract investment. This is the hope of many states when they enact relocation incentives.

Of course, Schaefer's model is not to be discounted entirely. Once a few states begin to enact incentives, the others will certainly respond in order to protect their interests. However, their responses are likely to be attempts to gain an economic advantage of their own, not attempts to merely neutralize the advantage of their neighbors. Schaefer's model characterizes all relocation incentives as measures that states would not enact but for the prisoners' dilemma in which they are trapped. I believe that this is overstated. While Schaefer is almost certainly correct that states often feel pressure to grant incentives to keep pace with other states, he fails to consider the possibility that states may be using incentives as a genuine attempt to make their state more desirable to outside investment.

The fact that the prisoners' dilemma can be manipulated in this manner shows the weakness of much of the literature on state investment relocation incentives. However, it also shows that there may be multiple reasons for state actions. The analysis of commentators who use a model similar to Schaefer's is certainly correct. States must be concerned with the actions of their neighbors. They cannot simply stand by idly and hope that no other state makes aggressive moves to attract industry. They must act out of fear for their economic self-interest, and they must act defensively. This defensive posture is only half the story. A state may enact incentives in an aggressive move to gain an economic advantage over neighboring

states. Both of these postures, defensive and offensive, must be considered when evaluating the reasons for a state's incentives.

The analysis may ultimately turn on the way in which the state *itself* views the costs of choosing to grant or not grant incentives. If we return to the prisoners for a moment, this becomes clear. In Schaefer's model, the prisoners choose to confess to protect themselves against what the other prisoner might do, whereas in Eichberger's model, the prisoners choose to confess in order to reach their preferred outcome. The states face a similar situation. If a state feels that it would be best off by not enacting incentives, but does so out of a protectionist impulse, it does indeed fit into Schaefer's model, and can aptly be described as trapped in the prisoners' dilemma. On the other hand, if a state feels that it would be best off by gaining an advantage over its neighbors with incentives, then Schaefer's model does not apply. This state would fit better into Eichberger's model, which indicates that the state is not trapped, but using the tools that it has at its disposal to maximize its return.

It may, in fact, be impossible to assign a meaningful value to the costs associated with (or sentences imposed by) the choices a state has. While the actual number of tax dollars that an incentive will cost a state can be determined, there are other intangible factors that a state must consider. Among these are the costs of other investment attraction improvements (e.g., worker training, education, infrastructure improvements), the potential for growth of secondary businesses, which would spring up around new industry, and the likelihood that industry may choose their state without incentives.

These costs are likely to be immeasurable. However, they do not need to be measured to demonstrate that states are likely to have different views of relocation incentives depending on their economic and social situation. Accordingly, they will have different views of the prisoners' dilemma. Some may feel trapped in incentive wars, whereas others may feel that they are benefiting from them. In any case, it is inappropriate to evaluate a state's view of the prisoners' dilemma without giving careful thought to how the state views its choices and the costs associated with them. That evaluation is critical in determining how to characterize a state's decision.

V. CONCLUSION

The economic community has not come to a settled conclusion on the matter of investment relocation incentives. However, there is an increasingly strong tide of disfavor towards them. The bulk of the empirical data suggests that incentives have at best little effect, and have the potential for damaging economic distortions. Thus, the states may be

engaging in a pattern of granting incentives that is ultimately damaging to their economic well being.

Nevertheless, there is real value in allowing states to make autonomous decisions regarding their economic development. State decisions affect neighboring states and the nation as a whole, and must therefore be monitored. Both the Dormant Commerce Clause decisions discussed and the Canadian Internal Trade Agreement provide necessary mechanisms for oversight. On the other hand, both the Supreme Court and the Canadian ITA recognize that federalism values local autonomy in economic decision making. When used effectively, the prisoners' dilemma can reflect this tension between beneficial and harmful consequences in state relocation incentives. However, when used ineffectively, the prisoners' dilemma only reflects the harmful consequences, thus portraying the states as locked in a downward spiral of ever-increasing tax credits.

It is true that states may face harmful consequences from granting (or refusing to grant) incentives. One must not make the mistake of extrapolating state motives from the consequences they face. A state may grant an incentive because it fears what other states may do. A state may also grant an incentive because it genuinely hopes that investment will relocate within their territory. The state's decision is a product of how it weighs the costs of each option. The prisoners' dilemma is a useful tool in framing the problem the states face, but it is not a comprehensive analysis of that problem. The model must be made flexible to fully reflect the different views a state may have of the costs of granting or not granting relocation incentives.